Eisner
Accountants and Advisors

Trends in Private Equity

Views & Insights for 2010

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INTRODUCTION

Private equity continues to evolve as an essential industry while the financial markets continue to recover from the resounding events of the past few years. A review of the current trends in private equity yields no earth-shattering revelations, yet they do reflect an industry in transition; an industry that is robust and ever-changing. This ability to transition with changing times is essential to its longevity.

Interview results gained through discussions with key private equity players along with Eisner's insights, are presented in this report. These insights could impact your thinking and, we hope, spur important discussions.

This report sheds light on the issues facing the private equity industry, as discussed by private equity industry leaders. Market and government forces will always challenge the industry's resilience. However, planning for these changes is essential to maximize investment value.

We hope you find this report useful and hope you'll share your thoughts and ideas with us.

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Executive Summary

Our review of in-depth individual interviews with general partners and other senior executives at private equity firms brought forth a number of key trends, views and insights presented here in summary.

1. The industry paradigm is shifting, causing a major realignment of industry standards; gone for now are the days of the mega-deal and the high volume of deal flow

Not surprisingly, scarce credit and recessionary conditions have impacted fundraising as evidenced in the decline of mega-deals (and deals in general). There is more focus and greater emphasis than ever before on mid-size deals, admittedly as these may be the only games in town.

2. Private equity firms will require even greater specialized sector, operational, and regulatory insight for the portfolio companies

Research continues to be important for private equity firms. Face-to-face discussions with trusted colleagues, industry experts and advisors are critical. The emphasis is on maximizing portfolio value. Scarce capital has also placed a greater emphasis on the need for more comprehensive risk assessment to support investment decision making. The importance of accurate valuations to support quality investments has never been more important.

3. Exit strategies have changed

Firms are finding themselves managing portfolio companies for longer periods of time. As exiting has become more challenging, greater emphasis is now placed on operations. One result is that M&A and IPOs have been impacted with a significant drop in volume. Gone are days of "quick flips" as multiples and valuations are depressed.

4. Two areas of tax concern

There are two areas that consistently come up as current priorities for private equity firms with regard to tax management: Tax structuring for holdings outside of the USA and tax treatment of carried interest.

5. More pressure on internal oversight and the likelihood of regulation is anticipated

This will require understanding regulatory implications and the impact of these is not yet clear. Most firms concur that regulation is, and will be, more about the rules addressing valuation and, generally speaking, any increase in government oversight will ultimately cause an increase in reporting with resulting obligations and costs. The general sentiment is that exemption rules may be changing, and hence this will impact private equity firms.

6. The cost and impact of fair value accounting is a concern

Fair value accounting is perceived as being designed to provide more transparency to limited partners rather than adding any value for private equity firms. As with increased government regulation, fair value accounting is expected to impact reporting at portfolio companies with more frequent closing of the books to allow valuation updates.

About the Research

Eisner engaged an independent market research firm to test and confirm trends in the private equity market. The firm conducted in-depth interviews with general partners, operating partners, and chief financial officers of U.S. private equity firms during the fourth quarter of 2009 and the first quarter of 2010.

The firms ranged in size from $400 million to over $4 billion in capital under management with portfolio companies in a wide span of industries, including but not limited to, manufacturing, services, IT, retail, consumer products, restaurants, real estate and technology. The private equity firms selected by the market research firm included both clients and non-clients of Eisner, and the interviews were all conducted by the market research firm. The interviews were solely about the industry and were not about Eisner and its services. The analysis and findings of the interviews presented in this report are considered to be directional.

Eisner Intelligent Data (Eisner ID) uses proprietary market research conducted by Eisner and leading market research firms, along with analysis from Eisner's partners and principals, to produce insightful articles, events and data designed to educate and stimulate discussion on the issues of most interest to business leaders today.

This report was prepared by Eisner LLP, and the information presented reflects the opinions of those interviewed, with the addition of Eisner's observations of industry trends, views and issues. While Eisner believes the information to be from reliable sources, it should not be relied upon as or considered to be investment advice.

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The Trends, Views and Insights

1. The industry paradigm is shifting causing a major realignment of industry standards; gone for now are the days of the mega-deal and the high volume of deal flow

Private equity deal volume continues be impacted by the troubles in the banking industry. With new fundraising impacted, there is a trend to smaller mid-market deals as well as minority investments rather than majority or full outright company purchases. In other cases, deals have been put completely on hold.

The interviewees felt that the private equity industry emphasis will continue to shift away from "megafunds" toward those funds that specialize in certain verticals or junior debt. In this environment, firms with specialized niches, good market upturn and, importantly, good market downturn strategies become attractive and viable.

From the interviews…

"In response to macro economic trends, things have changed with evaluating investments and our portfolio companies."

"Valuations of the company are much more transparent and shared with limited partners every quarter which did not happen before. So you're under pressure to explain variances…it's almost like being a public company."

After a quiet period, initial public offerings appear to be re-emerging as a viable exit strategy. While global IPO activity has picked up, especially in Asia, the volume of IPOs is not near historical levels. The initial stock pricing is still an issue with lower than desired price attainment. Mergers and acquisitions activity remains low.

Given this, our interviewees tell us that more attention is being paid to increasing the value of portfolio companies without the option of leverage – which is especially challenging in the face of potential quarter-to-quarter reporting requirements. This has placed increased importance on due diligence and understanding the competitive trends and contexts in which portfolio companies are operating.

Limited partners are placing increased importance on transparency. They are paying attention to the quarterly results at portfolio companies and the methods used to calculate them.

2. Private equity firms require additional specialized sector, operational and regulatory insight for the portfolio companies

In lieu of new fundraising, funds are placing more focus on increasing the value of their portfolio companies. According to interviewees, they are paying more attention at the portfolio companies to

- debt structures
- quality of earnings
- risk management
- IT structure
- marketing and competitive intelligence
- operational efficiency

These areas hold the promise for increased earnings and the assurance of portfolio company performance to financial budgets.

For both financial reasons (i.e., decreased costs) and competitive reasons, there seems to be a growing interest in having research conducted in-house. Private equity firms are returning to their roots in the absence of leverage. That is, they are exerting their effort on really knowing their portfolio investments intimately so they can improve their values in a "hold" environment.

Scarce capital has also placed a greater emphasis on the need for more comprehensive risk assessment to support investment decision making. The importance of accurate valuations to support quality investments has never been more important.

From the interviews…

"Substance is more important. We have 'go-to' firms for their substance. We get a basic report from the experts and that is satisfactory."

"We are starting to review portfolios of companies where we sit down and go over data, see what the budget is, and examine their performance to the budget."

"We are starting to look at portfolio companies' financial data which is something that was originally only done by the CFO. Now the Board does this also."

It appears that when private equity firms turn to third-party firms for assistance in research, they segregate their needs into specific areas and choose to work with specialist firms. Generalists do not offer private equity partners the expertise or depth they desire. Expert assistance is of strategic importance.

3. Exit strategies have changed

Private equity firms continue to look for ways to increase the value of existing portfolio companies, including, but not limited to:

- Identifying excess cash flows that can be used to pay dividends to investors, and
- Reducing debt to free up working capital for new strategic hires

Private equity firms are seeing the IPO re-emerge as a viable exit strategy. However, because of how far values have fallen and the retrenchment that has taken place, they may be reluctant to issue an IPO. They cite concerns over a dilution of their own investment and reduced influence over their portfolio companies.

M&A remain an option, provided a true complementary need exists – such as an identified need in a portfolio's service offering being filled by a niche player. However, seemingly gone are the days of M&A simply for the sake of growth and inflated valuation.

For the most part, private equity firms are hands-off with regard to the day-to-day operations at portfolio companies. They may work with and monitor senior management with a focus on the big-picture strategy. In addition, they may push for new or better use of financial reporting systems to generate more operating metrics about the operations.

Deep sector experience and knowledge is a strategic imperative. Closer relationships with the portfolio companies' management teams or positions on their boards are an added advantage. Personal relationships have and will continue to be an important way for firms to generate deals.

Private Equity Industry Issues

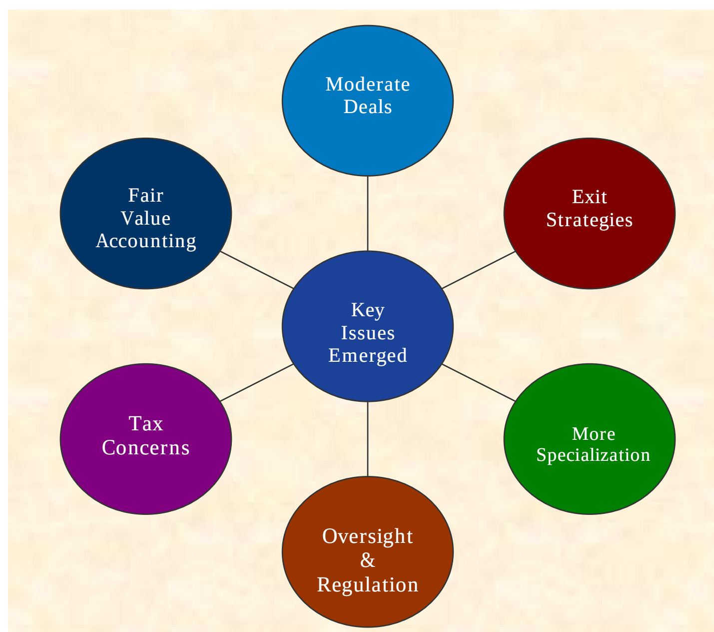

Figure 1 - The above highlights the 6 trends which emerged from the research

From the interviews…

"Private equity, by definition, is about bringing change and improving systems."

"We are spending more time on the existing portfolio…financial management is staying much more on top of the company's financial reporting, so we can stay ahead of any issues that might be surfacing over the next four quarters."

"We are working with companies that have much better cost management, with everything from reducing staff, to taking cost out from operational or financial areas."

4. Two areas of tax concern

Tax management for private equity has been typically viewed as more relevant on the fund side rather than the portfolio company side. The interviewees brought up some additional concerns. The two areas that consistently came up as current priorities for private equity firms with regard to tax management were:

- Tax structuring for holdings outside of the USA
- Tax treatment of carried interest

When the portfolio companies of a fund are owned and operated in multiple-countries, private equity firms say that they need to seek strategic international tax expertise to ensure that they are maximizing their portfolio's value.

From the interviews…

"We had a couple of deals with international companies and the amount of complexity around corporate structuring has been unbelievable."

"A lot of CFOs don't manage tax information aggressively."

"The other thing for us is international tax strategy, especially if you're involved in a multinational company, where there are reasons you need to structure things a little bit differently."

They were referring to tax advice required for both the fund and the portfolio companies in the case of international transactions. Since portfolio company value maximization can be impacted by business structuring and the associated tax treatments, interest in this topic is growing. The fund managers identified that the tax treatment for international companies has turned out to be far more complex than they had anticipated. A more proactive understanding of multinational and foreign company structuring has become necessary for private equity firms both when structuring the original transactions as well as for looking ahead to future exit strategies.

The second area of tax concern among private equity fund management regards potential regulatory activity with the treatment of carried interest. Private equity firms are carefully watching this for the proposed changes in tax rates for capital gains versus ordinary income. As expected, preserving the bottom line is paramount.

5. More pressure on internal oversight and the likelihood of regulation is anticipated

Private equity firms tend to equate regulation with rules about valuation and the costs of increased reporting requirements. If reporting requirements increase, private equity firms may find they are not adequately staffed to handle the additional workload. Outsourcing of this function will be a viable solution.

As it currently stands, private equity firms are exempt from many of the oversight treatments that other types of investments face such as daily and quarterly reporting requirements and registration with the FTC. The interviewees said that they are not currently focussing on changing their internal processes or standard procedures in anticipation of regulation.

The private equity firms interviewed noted that they would like to be consulted on potential regulatory changes. They felt that the government was not soliciting sufficient input from the industry especially concerning the implications of the proposed actions.

The private equity firms interviewed stated that they currently feel increased governmental presence in some of the sectors where their portfolio companies compete.

From the interviews...

"Everything [will change] from fund raising to the operation of the fund...how much leverage you can take down, what kind of reporting you can do, how much transparency there is. It's government bureaucracy at work. Not value added and much more work."

"Maybe in the near future, private equity firms are going to end up having to be registered with the FTC and it's going to create no value and a lot of cost for everyone."

"Government regulation will have private equity step back and look at their structure and work."

Most felt an increase in the amount of time spent monitoring their portfolio companies' sectors' competitive environment and important regulations. For example, the automotive and healthcare industries stand out as clear examples where the knowledge of government policy changes or actions would play a key role in deciding on investment. This type of information has a significant impact on their existing and potential investments.

From the interviews...

"Fair value accounting causes us to do a lot more work to value the company."

"Now we go through every single portfolio, every quarter. We used to do that once a year."

"Fair value accounting is pretty straightforward to understand."

6. The cost and impact of fair value accounting is a concern

Fair value accounting is perceived as being designed more for the investors than for private equity firms. It is intended to provide the limited partners with a better understanding of valuations and hence transparency. LPs would get updates more frequently than they are currently used to.

With the requirement to provide more frequent valuations, the interviewees said that fair value accounting is "synonymous with more paperwork." The frequency of portfolio company performance reporting would be increased. Most private equity firms have already designed and established data collection practices and reporting standards. They have developed home-grown methods to meet their needs using spreadsheets and other simple reporting tools.

In conclusion

Private equity, like most sectors, has its challenges; yet it continues to adjust its value proposition to best serve its constituency. A review of the trends and leaders' insights in private equity helps to ground us all in the realities of today, coupled with learnings from the recent past. This is important in helping us engage in productive dialog about private equity's future trends and implications.

ABOUT EISNER

Eisner LLP is one of the premier accounting and business advisory services firms in the country. Founded more than 45 years ago, Eisner provides auditing, accounting, and tax services to public and private firms across North America and internationally. The firm's primary concentrations are in financial services; technology, sports and media; services to public companies and personal wealth advisory services. Eisner provides services to over 150 private equity firms and 600 hedge funds. Eisner also offers a complement of business advisory services in corporate finance, litigation consulting and forensic accounting, bankruptcy and insolvency, employee benefits, entrepreneurial and start-up services, internal audit and risk management among others. Eisner's clients, from individuals through mid-size companies to Fortune 500's all share a requirement for responsiveness that is the hallmark of Eisner's client service mission. Eisner's headquarters are in New York City with offices on Long Island, New Jersey and the Cayman Islands. Eisner is an independent member of PKF International. Visit us at www.eisnerllp.com.

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